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CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

No. 188.

BRONX COUNTY TRUST COMPANY, as successor to Fordham National Bank in New York,

Petitioner,

AGAINST

A. BRUCE BIELASKI and KEYES WINTER, as surviving Trustees in Bankruptcy of Benedict Metal Works Inc.,

Appellees.

Brief of Trustees in Bankruptcy in Opposition to Petition for Writ of Certiorari.

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By this application for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit, the petitioner seeks to have this Court accept for review an order of the said Circuit Court affirming, without opinion, the judgment of the United States District Court for the Southern District of New York in favor of the trustees and against the petitioner in the sum of $38,906.62. The opinion of the District Court (Rippey, *D. J.*) is reported (14 F. Supp. 971).

The action was by the trustees to recover, as unlawful preferences, three payments made by BENEDICT METAL WORKS, INC., the bankrupt, to the petitioner.

Both Section 15 of the Stock Corporation Law of the State of New York and Section 60-b of the Acts of Congress relating to bankruptcy (United States Code, Title XI, Chapter 6, Section 96 [b]) were alleged to have been violated.

On this application, the petitioner contends, as it did in the court below, that the order of the Circuit Court of Appeals and the judgment of the District Court are erroneous for three legal reasons, viz., (1) that the payments to the petitioner did not deplete the estate of the bankrupt; (2) that the record does not contain any proof of intent of the bankrupt to prefer the petitioner or that the petitioner knew or had reasonable cause to believe it was being preferred by the payments made to it by the bankrupt (Section 60 of the Bankruptcy Act); (3) that the record does not contain any proof of the insolvency or imminent insolvency of the bankrupt at the time of the payments.

Apart from the question of insolvency or its imminence, the points made by the petitioner arise from the following facts, as to which there was no substantial dispute:

One Sparler was the bankrupt's vice-president, treasurer and general manager. The bankrupt, a corporation, had conferred upon Sparler full and complete authority to sign and endorse commercial paper and to discount the same at various banks, including the petitioner. Regardless of his official title, the bankrupt, its business and finances were completely dominated and controlled by Sparler. To keep the bankrupt in business, Sparler secured bank credits by endorsing for discount and discounting a large number of spurious receivables (promissory notes and trade acceptances) for the bankrupt's account at various banks, including the petitioner. In addition, he borrowed large sums of money upon the discount of the bankrupt's own paper, beguiling the banks with false financial statements. By these methods, Sparler established for the

bankrupt a substantial revolving fund, in that moneys raised at one or more banks were used to take up maturing items at the same or other banks. The proceeds of all discounts went into the accounts of the bankrupt. Detection of Sparler's forgeries or his utterance of forged papers was avoided for a long time by meticulous prepayment of those papers. He never permitted a paper to be presented to the purported maker or acceptor. The bankrupt's (and Sparler's) troubles began, however, when, in the spring of 1928, Sparler gave The National City Bank of New York six notes, each in the sum of $11,650.00, bearing the name of one Ball as maker, as collateral security for some borrowing which Sparler had arranged upon the bankrupt's own notes. Ball, although a resident of Indiana, was known to the officers of that bank as a man of great affluence. That Ball should have outstanding notes of long maturity aroused suspicion and prompted investigation. Ball promptly repudiated the notes and the bankrupt, through Sparler, was compelled forthwith to clean up its indebtedness to The National City Bank of New York. Part of the payment made to that bank has been recovered by the trustees (*Bielaski* v. *National City Bank*, 58 F. [2d] 657, affirmed 67 F. [2] 723).

Later, other banks, including petitioner, learned of Sparler's crimes and applied pressure to get their notes and receivables paid. In desperation, Sparler sought still other banks which he could similarly dupe. He succeeded in prevailing upon The Nassau National Bank of Brooklyn to give the bankrupt a liberal line of credit on its own papers as well as on receivables. Through the discount of the bankrupt's own papers and of forged receivables with the latter bank, the bankrupt raised the money necessary to take up three admittedly forged receivables held by the Fordham National Bank in New York (now the petitioner). Each of the payments made by the bankrupt to the petitioner emanated from the bankrupt's account with The Nassau National Bank of Brooklyn.

From the record, it is impossible to ascertain whether the payments to the petitioner were made from moneys raised upon the bankrupt's own papers or upon forged receivables. The first of the three payments was made on May 11, 1928, by check of the bankrupt in the sum of $4,132.30 drawn on its account with The Nassau National Bank of Brooklyn. The second was accomplished by a debit charge of $11,650.00 on May 23, 1928, against the account of the bankrupt with the petitioner. This debit charge and payment were made possible by a transfer of funds of the bankrupt from The Nassau National Bank of Brooklyn to the petitioner. A check of the bankrupt on the former was deposited in the bankrupt's account with the petitioner on May 17, 1928. Without this deposit, the charge and payment could not have been made. The third payment was made on June 21, 1928, by the bankrupt's check of $11,650.00 drawn on the petitioner. Another transfer of funds from the bankrupt's account with The Nassau National Bank of Brooklyn made this payment possible. This transfer was made by check of the bankrupt to its order drawn upon The Nassau National Bank of Brooklyn and deposited in its account with the petitioner on June 20, 1928. The record shows that from May 9, 1928, The Nassau National Bank of Brooklyn discounted forged receivables for the bankrupt's account, and in addition the bankrupt's account was also credited with the proceeds of discounts of its own paper.

POINT I.

The bankrupt's estate was depleted by the payments made to the petitioner.

The above point is the converse of the first argument made in petitioner's behalf on this application. Essentially, the contention is made that because Sparler defrauded The Nassau National Bank of Brooklyn in

obtaining the funds with which the petitioner was paid, the funds, although raised on the authorized signature of the bankrupt, were not the property of the bankrupt immediately prior to such payment. To whom the money belonged is not stated, but the suggestion is made that The Nassau National Bank of Brooklyn "could have set aside the transaction for fraud and reclaimed the same as its property" if found in the possession of the bankrupt or the trustees.

In making this contention, the petitioner ignores the fundamental principle of contract law that fraud does not *ipso facto* avoid a contract. It is merely voidable at the option of the defrauded party (*Conrow* v. *Little*, 115 N. Y. 387). In Sparler's dealings with The Nassau National Bank of Brooklyn, he was clothed with the authority to sign and endorse paper for discount for the bankrupt's account. The bankrupt became liable to the bank on all paper which it discounted for the account of the bankrupt on the signature of Sparler as its authorized agent. Each discount, whether of the bankrupt's paper or a receivable, involved a contract between the bankrupt and the bank, and regardless of any fraud (forgery or false financial statement) the contract existed. Each such contract imported an obligation to pay the bank a sum of money and, in the case of the discount of receivables, the endorsement of the bankrupt bound it to the warranties and engagements imposed by law upon a general endorser (New York Negotiable Instruments Law, §§115 and 116). In each instance of discount the bank credited the bankrupt's account with the proceeds. The bankrupt became the owner of the credit.

True, the bank, because of the fraud perpetrated upon it, might have rescinded the discount contracts and cancelled the credit, or, if the money had been transferred and could be traced, the bank might "have asserted possession of it on the ground that there was a resulting trust in their (its) favor, or they (it) could have

established a lien for what was due them (it) in any fund of which he (the bankrupt) had made it a part'' (*Cunningham* v. *Brown,* 265 U. S. 1).

The Nassau National Bank of Brooklyn did not rescind the discount contracts. It filed a general claim in the bankruptcy proceeding on the discount contracts. Accordingly, any question of title to the funds in the bankrupt's account representing the proceeds of discounts is completely obviated. Such funds were clearly the property of the bankrupt available to meet the claims of its creditors. The transfer of such funds to pay indebtednesses owing to the petitioner constituted a depletion of the bankrupt's estate.

The remainder of petitioner's argument of non-depletion overlooks the power and authority conferred by the bankrupt upon Sparler to sign and endorse commercial paper in its name. That Sparler had such general power and authority is admitted. When he exercised such power and authority in the discount of notes and acceptances, the bankrupt's account (not Sparler's) was credited with the proceeds. The moneys were invariably used for corporate purposes (fol. 558). Sparler's forgeries were personal crimes in the sense that they were not authorized or consciously sanctioned by the bankrupt. But the corporation benefited thereby and because it had conferred upon Sparler the authority to borrow money in its name, the fact that Sparler violated the criminal law in order to accomplish such purpose does not relieve the bankrupt of liability on the discounted paper or deprive it of ownership of the proceeds of the discounts. The ownership of such bank credits is a necessary corollary to the bankrupt's liability on the discounted paper.

The position of the petitioner with respect to its claim of $32,500.00 against the bankrupt is inconsistent with its claim of non-depletion. In addition to the three papers, the payment of which has been adjudged preferential, the petitioner holds the bankrupt's discounted

note of $32,500.00 signed by Sparler for which it has filed a general claim. This loan was induced by a false financial statement of the bankrupt which Sparler furnished to the petitioner. The books of the bankrupt did not disclose the liability on this paper (fol. 802, petitioner's brief, p. 7). It was, however, entered in the "John J. Sparler Special Account".

If the petitioner's argument is sound, that by such paper the bankrupt incurred no liability and the disbursement of the proceeds of the discount thereof did not result in depletion, how can it maintain that it has a claim against the bankrupt's estate on the note of $32,500?

On the question of the liability of a corporation for the acts of an officer, the petitioner cites two cases of recent origin, namely, *Credit Alliance Corp.* v. *Sheridan Theatre*, 241 N. Y. 216, and *Hoberg* v. *Sofranscy*, 248 N. Y. 141. Neither case involved a preference. The decision in both turned on the question of authority to sign or endorse notes. In both cases the plaintiff failed because authority was lacking. Those cases are distinguishable from that at bar in that here Sparler's authority was unquestioned.

Stated simply, the instant case was decided, not on the answer to the question whether Sparler was acting for the bankrupt in forging papers or issuing false financial statements, but upon the issue whether he had the authority to bind the bankrupt on a note or endorsement. The latter authority he concededly had. It was proper, therefore, to exclude testimony offered by the petitioner that Sparler was never expressly empowered to commit crimes in the corporation's behalf (fols. 555, 556).

All of the borrowings by Sparler in the bankrupt's name went into the bankrupt's accounts. Such funds, regardless of the devices or methods by which they were obtained, were available to its general creditors unless and until reclaimed by the defrauded lenders.

Payment to the petitioner out of such funds depleted the assets of the bankrupt and, if the other elements of a preference have been proved, the petitioner obtained a greater share of the bankrupt's assets available to its creditors than others.

In urging the point of non-depletion, the petitioner ignores its pleading (answer to the amended complaint, Transcript of Record, pp. 12-15). The trustees alleged in their amended complaint (Paragraphs Eighth and Sixteenth, fols. 17, 22) as amended on the trial (fols. 54, 56) that the payments were made by the bankrupt. These allegations were not put in issue. Accordingly, depletion is admitted and no issue on that proposition existed. The District Judge so held (fol. 1260).

POINT II.

The bankrupt intended to prefer the petitioner.

Admittedly, Sparler committed many crimes over a long period to keep the bankrupt from financial collapse. There is no denying that for all practical purposes, he was the bankrupt's *alter ego*. Of course, he knew of its insolvency. "A concern that is solvent does not raise money by means of forged paper" (PATTERSON, *D. J.* in *Bielaski* v. *National City Bank*, 58 F. [2d] 657, 660). The practice of "robbing Peter to pay Paul" must have been done with the consciousness that when the crimes were discovered "Peter" would be sacrificed because "Paul" had been paid. Such consciousness is tantamount to the prohibited intent. That intent is admirably expressed by Judge Learned Hand in *Matters* v. *Manufacturers Trust Co.*, 54 F. (2d) 1010, 1014, where he said:

> "It is still a preference if a debtor, knowing that he is insolvent, selects one creditor, though he believes he will not go to the wall, if the dice

> fall right. He must actually believe that the gods will smile; it is not enough that their faces are inscrutable.''

It is inconceivable that Sparler, acting for the bankrupt, could have had a real belief that the bankrupt would succeed to the point where it would continue in business and pay its creditors in full. This is particularly so since Sparler's crimes had already been detected by several of the banks duped by him and his financial operations seriously curtailed. The end was drawing near.

The petitioner maintains that the business of the bankrupt was being continued with no idea of liquidation or winding up and argues therefrom that the unlawful intent could not have existed. The record shows that the bankrupt's business was being operated at a substantial loss for a long time and in April, 1928, the directors of the bankrupt acknowledged that it was in financial difficulties (Plaintiffs' Exhibit 19, fol. 1156). Even assuming that, regardless of insolvency, a voluntary liquidation was not in contemplation, it is evident that enforced cessation and winding up of the business was ever imminent because of the frauds which Sparler, in the bankrupt's behalf, had perpetrated.

It is difficult to imagine a case where the finding of an intent to prefer would be more justified.

POINT III.

Under Section 15 of the Stock Corporation Law of the State of New York as it existed when the payments were made to the petitioner, its belief that a preference would be effected was of no moment.

The petitioner is in accord with the point. If, therefore, as found by the trial court, the payments were made when the bankrupt was insolvent or imminently

so and it intended a preference thereby, the trustees' cause has been sufficiently established to entitle them to a recovery under the state statute, regardless of the consciousness of the petitioner at the time of the payments. Accordingly, even if the trustees have failed by their proof to sustain a bankruptcy preference (the courts below allowed a recovery under the bankruptcy statute as well as the state law) there is still no basis for disturbing the judgment.

POINT IV.

The petitioner knew or had reasonable cause to believe it was being preferred.

It is undoubtedly the law that notice of facts which would incite a man of ordinary prudence to an inquiry is sufficient to charge a creditor with knowledge of facts which a reasonably diligent inquiry would have disclosed (*Pender* v. *Chatham,* 58 F. [2d] 968, 970). Section 60 of the Bankruptcy Act does not require that the creditor have actual knowledge, either of insolvency or that a preference would be effected, but the test is: do the facts within the knowledge (actual or constructive) of the creditor justify the inference or belief that a preference was being given?

The District Judge held that because the petitioner had "discovered" on and after April 28, 1928, the spurious character of the paper Sparler had been discounting for the bankrupt's account, it was put upon inquiry and was chargeable with knowledge of the insolvency of the bankrupt and of the resulting preference which the payments effected. The testimony of the petitioner's president (Miller, fols. 86-93) and its credit manager (Stearns, fols. 435-473) left no opportunity of escape from the conclusion that the petitioner was put upon inquiry. Such inquiry would necessarily have disclosed the bankrupt's insolvency and that the peti-

tioner was being preferred. When evidence of forgery by a debtor is at hand, it is idle to argue, as petitioner does, that "suspicion" is insufficient upon which to predicate reasonable cause to believe the debtor to be insolvent. This is especially so when it is considered that after learning of Sparler's irregularities, the petitioner "persuaded" the bankrupt to anticipate the maturity of the forged papers.

A more convincing case of "reasonable cause to believe" is difficult to conceive.

POINT V.

The finding of insolvency or imminent insolvency of the bankrupt was warranted by the proof.

The record presented a fair question of fact on the issue of the bankrupt's insolvency. In view of the large amounts involved in the forgeries, the imminence of insolvency is hardly debatable. The finding that $215,000 of its liabilities were not converted into capital was clearly justified by the proof that the certificate of increase was not filed until June 20, 1928 (the day upon which the last payment was made to the petitioner) and that nothing was done thereafter to accomplish the increase. All that appears in the record is that an option to purchase the stock upon the increase was given to Friedman, who, with Sparler, became a creditor of the bankrupt when they furnished the equities to take up the bankrupt's obligation to the Bronx Borough Bank and Cosmopolitan Bank.

Insolvency was unquestionably shown. At best, the petitioner may assert that the proof presented a question of fact on that issue. That question has been resolved against the petitioner and, of course, this Court will not substitute its judgment of the facts for that of the courts below.

No legal question is presented in the petitioner's point of lack of proof of insolvency.

CONCLUSION.

The petitioner has failed to present any substantial legal question for review by this Court and, accordingly, certiorari should be denied.

Respectfully submitted,

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